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# ETIs: A SCHEME FOR THE RESCUE OF CITY AND COUNTRY WITH PENSION FUNDS

*Alvin D. Lurie†*

## I. INTRODUCTION

Most observers of Washington would not recognize the term “economically targeted investment” (“ETI”). ETI is basically a scheme for using the funds of both public and private pensions to invest in, say, community projects like building bridges. But despite the term’s obscurity, a curious spectacle unfolded on Capitol Hill last year. The House of Representatives passed an unusual bill<sup>1</sup> to bar the Department of Labor (DOL) from guiding pension fund managers in considering these investments.

The House of Representatives was responding to a brief announcement by DOL<sup>2</sup> which was designed to alleviate apprehension among pension plan trustees concerned about the contamination that a motive outside plan participants’ benefits would cause. In IB 94-1, DOL asserted that it wanted only to clarify the conditions under which pension plan fiduciaries could engage in ETIs.

This article will prove that ETIs pose no greater problem than many other conventional pension investments, such as junk bonds and derivatives. Further, this article will argue that the Labor Department acted properly to enhance the soundness of pension funds and the security of plan participants’ pensions. To be sure, DOL’s guidance will certainly benefit pension participants more than the absence of any guidance.

DOL’s motives for making the announcement may stem from the political objectives of the Clinton Administration to facilitate and encourage the use of pension funds to advance social agendas. The motive does not automatically tarnish DOL’s endeavors, but it was enough for the House of Representatives to issue a statement that it was inappropriate.

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<sup>1</sup> H.R. 1594, 104th Cong., 1st Sess. (1995).

<sup>2</sup> Dept. of Labor [hereinafter DOL] Interpretive Bulletin 94-1 [hereinafter IB 94-1], Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32,606 (1994) (to be codified at 29 C.F.R. pt. 2509).

ate for DOL — the principal enforcer of pension law — to promote or encourage ETIs.

## II. TERMS OF THE DEBATE

ETIs can do vast good for society, but they also have the potential to wreak disaster on pensions. Thus, these investments ignite strong rhetoric from both their supporters and detractors. The Ford Foundation reported in a recent study that:

[t]he subject of ETIs remains very controversial. Among other things, the controversy stems from: perceived conflicts with fiduciary duty; a conflict with generally accepted investment principles such as diversification; a confusion about the definition of the term; and a concern that demands for ETIs will infringe on a fund's independence.<sup>3</sup>

The Ford Foundation attempted to overcome the problem of defining ETIs with a definition of its own: ETIs are "designed to produce a competitive rate of return commensurate with risk, as well as to create collateral economic benefits for a targeted geographic area, group of people or sector of the economy."<sup>4</sup> But we may need a brand new term rather than just a better definition. Even the same initials would work: "ETI" can stand for "extraterrestrial investments" (as in investments outside the normal terrain of pension trustees.) They can also stand for "TOP," an acronym for "The Other Path" (as in alternative investment routes.) Trustees could then "Top up" the plan, and the phrase would convey an affirmative investment strategy; but, unlike the phrase now in use, it would not also convey the baggage of affirmative action.

In the face of increasing unemployment, Secretary of Labor Robert Reich has urged pension investors to look for something more than just the dollar rate of return. When he met with a major trade group which represents large corporate and public pension funds, Mr. Reich argued that "over-reliance on balance-sheet ratios—for instance, return on capital, assets and invested capital — ignores a human dimension that can affect long-term corporate performance."<sup>5</sup> Listeners reminded Secretary Reich that, while they were willing to look at nonfinancial indicators, such data could only be a supplement to — not a substitute for — basic financial analysis.

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<sup>3</sup> REPORT OF INSTITUTE FOR FIDUCIARY EDUCATION, ECONOMICALLY TARGETED INVESTMENTS — A REFERENCE FOR PUBLIC PENSION FUNDS, Executive Summary, Ford Foundation, June, 1993 [hereinafter Ford Report].

<sup>4</sup> *Id.* at 5

<sup>5</sup> See BNA PENSION & BENEFITS DAILY, Mar. 29, 1993.

Another concern of the Clinton Administration is that important business segments, which traditional providers of capital underserve, are finding it difficult to acquire investment capital. Funds, after all, are increasingly concentrated in the hands of institutional investors, which favor publicly-traded securities investments in main-line projects.

A DOL advisory group has studied ways for these groups to gain access to pension funds, inasmuch as increasing share of long-term savings is flowing into the pension system at the very time that banks, which operate under new stringent capital requirements, have withdrawn almost entirely from secondary investment programs.<sup>6</sup> The DOL advisory body concluded that many sound investments exist in areas that pension funds do not usually target, and that, by investing in projects which are of local or occupational interest to a pension fund's participants, the funds can create a "primary benefit from competitive financial returns and a collateral benefit from the creation of jobs, wealth, and other local economic ripple effects."<sup>7</sup>

On the other hand, one commentator has characterized ETIs as "hardly any less larcenous than the sweetheart loans the mob took from the Teamsters Central States Pension Fund."<sup>8</sup>

Even a group of pastors from the Evangelical Lutheran Church of America refused to use their pension money for the public good. Thirty pastors sued the parent body and its pension board for violation of fiduciary duties by allegedly basing pension investments on a social agenda rather than on the best financial interests of pension participants.<sup>9</sup>

People resist ETIs because they believe that the investments are concessionary and involve some sacrifice of return.<sup>10</sup> The Ford study found that the most frequent reason public systems give for not investing in ETIs was the belief that doing so conflicted with the pension fund's

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<sup>6</sup> See WORK GROUP ON PENSION INVESTMENTS OF ADVISORY COUNCIL ON PENSION, WELFARE & BENEFIT PLANS OF DOL, ECONOMICALLY TARGETED INVESTMENT — AN ERISA POLICY REVIEW (Nov. 1992) [hereinafter DOL ADVISORY REPORT].

<sup>7</sup> *Id.* at Executive Summary.

<sup>8</sup> David Andrew Price, *Pensions Ripe for Democrats Plucking*, WALL ST. J., Aug. 18, 1993, at A10.

<sup>9</sup> *Basich v. Board of Pensioners, Evangelical Lutheran Church in America*, 540 N.W.2d 82 (Minn. App. 1995) (Establishment Clause prevents state courts from determining whether ELCA broke contract with its clergy by directing its pension board to base its investments on moral and social concerns; Freedom of Conscience Clause in Minnesota Constitution, which bars government action burdening exercise of religious beliefs, does not give court jurisdiction).

<sup>10</sup> See also Edward A. Zelinsky, *ETI, Phone the Department of Labor: Economically Targeted Investments, IB 94-1 and the Reincarnation of Industrial Policy*, 16 BERKELEY J. EMPLOYMENT & LAB. L. 333 (1995) [hereinafter *Phone DOL*]; John H. Langbein, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile and Illegal, in DISINVESTMENT — IS IT LEGAL? IS IT MORAL? IS IT PRODUCTIVE?* (1985) [hereinafter *DISINVESTMENT*].

fiduciary duty. Indeed, Professor Edward Zelinsky argues that even acknowledging that collateral factors enter into the fiduciary's *Buy* decision taints the transaction; it automatically runs afoul of fundamental ERISA principles such as interest sole, prudence, and exclusive benefits.<sup>11</sup> The principle of exclusive benefit, for example, runs through all the pension regulatory statutes, and it requires the formation, management, and maintenance of pension plans "for the exclusive purpose of providing benefits to participants."<sup>12</sup> Thus, Professor Zelinsky argues that trustees' admitting or pursuing any other purpose — however praiseworthy — simply violates the principle.

But it is an unworkable standard to permit an investment to incidentally benefit some "externality" while simultaneously forbidding a trustee from admitting that this social benefit influenced his action. The fiduciary would then be in the awkward position of choosing between disingenuous denial or candid confession.

Moreover, ETIs must satisfy the standards of prudence, diligence, skill, and risk-adjusted market return — standards which apply to every kind of pension investment. Further, the plan fiduciaries must avoid self-dealing and other prohibited transactions. In fact, DOL's announcement in no way approves anything less for an ETI; DOL warns that it will not encourage any derogation or subordination of the plan's interests, and the plan fiduciary who fails to observe these strictures does so at its extreme peril.

IB 94-1 is a response to the general concern among pension trustees that "even minimal evidence that something other than participant welfare has motivated trustee behavior triggers the standard's protections."<sup>13</sup> That concern informs the recent report of the Employee Benefits Committee of the Association of the Bar of the City of New York which urges "further clarification from the DOL . . . [to] reduce the likelihood that ERISA fiduciaries will reject prudent ETIs solely because of uncertainty in the law."<sup>14</sup>

Because great confusion surrounds the issue of "social" investing — a term which includes not just subsidized investments, but even those investments that also satisfy the market's requirements for a competitive, risk-adjusted return — plan trustees would like to know DOL's official position on the subject. This knowledge is valuable even for the cautious

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<sup>11</sup> See *Phone DOL*, *supra* note 10.

<sup>12</sup> Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended primarily in 29 U.S.C. 1001-1114 (1982 & Supp. 1988)); I.R.C. § 401(a) (1990); Treas. Reg. § 1.401-2(a).

<sup>13</sup> *Phone DOL*, *supra* note 10, at 343-44.

<sup>14</sup> COMM. ON EMPLOYEE BENEFITS, *Report of the Ass'n of the Bar of the City of New York, in THE RECORD OF THE ASS'N OF THE BAR OF THE CITY OF NEW YORK* 578 (June 1995) [hereinafter ABC REPORT].

fiduciary, who might want assurances from the judiciary or counsel. Nevertheless, it helps to have the government — or, at least, the Labor Department, which no doubt acts with the tacit approval of the White House — bring the “incidental benefit” issue out of the closet.

For DOL to have acknowledged the legitimacy of incidental benefit considerations is valuable; but acknowledging that the exclusive benefit rule does not prevent the trustee’s investment decisions from serving interests other than the participants’ would be more so. Even Professors Fischel and Langbein, who certainly do not support ETIs, have basically said that there should be some “give” in the exclusive benefit doctrine so that courts do not need to resort to the fiction of “incidental benefits” to get around its proscription.<sup>15</sup>

Make no mistake, introducing collateral considerations into the investment equation invites improper influences and attracts administrative and even judicial remedies: fiduciary penalties and injunctions, civil and criminal remedies, and, sometimes, plan “disqualification.”<sup>16</sup> But these legal remedies also serve as adequate counterbalance.

### III. AN OLD NEW IDEA

The concept of the ETI has been around for a long time. The Clinton Administration, however, fueled public interest when it placed ETIs under the spotlight. News accounts from the time of the President’s inauguration identified — among the legislative initiatives Clinton’s transition team was drafting for sparking the lagging economic recovery — a proposal to create incentives for pension funds to buy bonds financing public works and environmental projects. Such suggestions, in fact, date back to the 1991 presidential campaign. Diverse figures such as the Reverend Jesse Jackson, investment banker Felix Rohatyn, and even Clinton himself advocated ETIs. Indeed, at least three of the new Cabinet appointees into HUD, Labor, and Transportation in their confirmation hearings also endorsed tapping pension funds for “the public interest.”

The idea has caught fire again recently, and cynics will say that the current focus on the pension funds is the Willie Sutton story all over again. Willie, remember, was the phrasemaker and bank robber extraordinaire. When someone asked him why he did what he did to banks, he is reported to have said (perhaps apocryphally), “That’s where the money is.” Maybe the cynics have gotten it right. At a time when raising taxes for any project — no matter how praiseworthy the cause — is

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<sup>15</sup> Fischel & Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI L. REV. 1105, 1158 (1988) [hereinafter Fischel & Langbein].

<sup>16</sup> I use the word “disqualification” in its technical sense, as the IRC does: to describe a plan that does not satisfy the requirements to qualify for the tax advantages in I.R.C. §§ 401ff, 501(a) (1990).

not a crowd pleaser, the pension funds are a tempting target. Throughout the 80s, Congress instead tapped the pension funds to close budget gaps. Now the Clinton administration embraces the idea of using pension money to rebuild the nation's infrastructure and inner cities. In circles where pension funds are sacrosanct, however, taking pension assets to build bridges, replace railroad tracks, and purify rivers is as damaging to retirement funds as Sutton was to banks.

#### IV. CONGRESS THROWS A BLOCK

DOL could not have anticipated the resistance its announcement generated on Capitol Hill, especially from Congressman Jim Saxton (R-NJ), whose position as vice chairman of the Congressional Joint Economic Committee commanded attention. Saxton first displayed hostility to IB 94-1 in his op-ed piece in the *Wall Street Journal*.<sup>17</sup> He contended that the Department intended to use IB 94-1 as a way of promoting the use of ETIs as a means of funneling pension money into "high risk, low return political projects."<sup>18</sup> Saxton then introduced H.R. 1594, his so-called Pension Protection Act of 1995, explicitly to nullify DOL's interpretive bulletin. After gaining the support of the GOP leadership, Saxton first succeeded in getting the approval of both the House Economic and Educational Opportunities Committee and the Joint Economic Committee of the full Congress. Then he secured passage by the House after watering down only some of the language to target more directly the Labor Department's actions instead of the ETIs *per se*.

H.R. 1594 expresses Congress' belief that it is "inappropriate for the Department of Labor, as the principal enforcer of fiduciary standards" — the job ERISA assigns to DOL — "to take any action to promote or otherwise encourage economically targeted investments."<sup>19</sup> The bill does not simply render IB 94-1 "null and void"<sup>20</sup> by directing Labor to rescind it; it adds insult to injury by prohibiting DOL employees from traveling, lecturing, or "otherwise [to] expend resources available . . . for the purpose of promoting, directly or indirectly, economically targeted investments."<sup>21</sup> It also prohibits federal agencies from maintaining or establishing a database or clearinghouse relating to ETIs, as DOL has proposed. Companion action in the House appropriations subcommittee would prohibit the DOL and the Pension Benefit Guaranty Corporation from using any fiscal year 1996 funds to implement or administer IB 94-1.

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<sup>17</sup> Jim Saxton, *A Raid on America's Pension Funds*, WALL ST. J., Sept. 29, 1994, at A12.

<sup>18</sup> *Id.*

<sup>19</sup> H.R. 1594, 104th Cong., 1st Sess. § 1 (1995).

<sup>20</sup> *Id.* § 2(a).

<sup>21</sup> *Id.* § 2(c).

The Senate, however, has shown no inclination to pass S.774, the companion bill to H.R. 1594, which Sen. Connie Mack (R-Fl.) introduced. HR 1594's becoming law would send the message to plan fiduciaries that choosing a plan investment to produce a collateral economic benefit would be a *per se* violation of federal law no matter how good the risk-adjusted rate of return. Moreover, trustees would have no interpretive guidance as to how to square investment policy with ERISA's fiduciary provisions in regard to plan investments.

It seems an abuse of Congressional power to deny an administrative agency the authority to provide such guidance, whether by rescinding individual rulings or by denying funds for implementing or enforcing same. Congress already has its hands full, with such global tasks as agreeing on a budget, defense, tax bills, health and welfare reform, and pension simplification, without getting into the business of micromanaging the minutiae of pension administrative pronouncements. For years Congress did not remedy far more significant concerns of pension administration, such as the overlapping responsibilities of IRS and DOL in the administration of ERISA's mirror provisions — which Congress itself, in enacting ERISA, foisted on the agencies and the public (inactivity which caused the public great inconvenience, until the White House itself finally defused the problem with its so-called "reorganization plan," as I discuss below).

Not everyone in Congress joined this anti-IB 94-1 effort. Rep. Clay (D-Mo.), speaking for many in his party, called it "pure; unadulterated demagoguery," and, drawing from a then recent movie, called the effort in the House "dumb, dumber, and 'dumb-agoguery.'"<sup>22</sup>

The Saxton bill will probably not be enacted; still, if nothing else, it shows us that even the hint of devoting private pension moneys to assist the work of government stirs up the most passionate debate. The Saxton bill, in fact, appears to be part of the larger debate that is now raging between the parties over just how much the government should be doing, directly or indirectly, to affect the commonwealth.

## V. INTERPRETIVE BULLETIN 94-1: WHERE'S THE BEEF?

Did IB 94-1 really warrant all this *Sturm und Drang*? Exactly what is Congressman Saxton's beef with the bulletin? Is it *that* radical an interpretation of ERISA's command that one invest pension funds prudently, solely in the interests of participants, and for the exclusive purpose of providing their benefits? Can we reconcile that requirement with ETI investments, which, as DOL defined them, are "selected for the economic benefits they create in addition to the investment of return to the

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<sup>22</sup> R.I.A PENSION & BENEFIT WK., Sept. 18, 1995, at 5.



EE benefit plan investor?"<sup>23</sup> No problem, says DOL, as long as the investment gives the plan a competitive, risk-adjusted rate of return. DOL does not proscribe risk *per se* as long as it is adequately compensated. That compensation would preclude an investment producing a lower return than another available one of equal risk, as well as an investment with a greater risk than another with the same rate of return. The comparison is, thus, between investments with similar risk characteristics, not between ETIs and blue chips; and ERISA does not forbid a pension portfolio that mixes risks, as long as the total portfolio legitimately fulfills the needs of the plan.<sup>24</sup>

There is nothing radical here. The Labor Department, in fact, went out of its way to fit its position on ETIs within the mainstream view of approved fiduciary behavior in selecting pension assets. It has not been obvious to the investment community that a pension plan can embark on a program of selecting investments in order to accomplish an economic objective irrelevant to the interests of both the participants and their plan benefits. Such benefits could include goals of improving infrastructure, creating jobs outside the participants' industry, providing local, low cost housing. A handful of private rulings from the Labor Department, during both Republican and Democratic administrations, approved socially motivated investment, but apparently did not displace the public's longstanding perceptions about a fiduciary's responsibilities. DOL maintains that it intended IB 94-1 only to debunk these longstanding perceptions.

As we have seen, encouraging such investments was the position of President Clinton even before he started running for the presidency. What better place to find the funds to "rebuild America" than the \$5 trillion now in pension funds? It certainly beats raising taxes in any politician's playbook. And that is exactly what bothers Congressman Saxton. He sees the DOL announcement as simply part of the Administration's scheme to expose private pension money to "high-risk, low return political projects."

Certainly nothing within the release supports this accusation; but, inarguably, just making the announcement in such a high-profile way is bound to increase the appeal of making economically targeted investments with pension funds. Secretary Reich, in answering the Saxton charge in an October 26, 1994 letter to the editor in the *Wall Street Journal*, denied that "government officials are going to have greater say in how pension plans invest their money."<sup>25</sup> But just because fiduciaries

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<sup>23</sup> IB 94-1, *supra* note 2, at 32,606.

<sup>24</sup> See Preamble to DOL regulation on investment of plan assets under prudence rule, 29 CFR § 2550.404a-1 (1979).

<sup>25</sup> Robert B. Reich, *Pension Fund "Raid" Just Ain't So*, WALL ST. J., Oct. 26, 1990, at op-ed page.

“will continue to make all investment decisions,” as he says,<sup>26</sup> Reich proves too much by giving insufficient weight to the fact that what government officials say affects pension investment behavior.

Of course, this Administration can contend, as it has in public testimony (citing both Republican and Democratic precedents), that it is not the first to endorse targeted investment actions by pension fiduciaries. What is new, however, is the repudiation of the term “social investing” in favor of the politically correct (if governmentese-laden) term “economically targeted investing.”<sup>27</sup> IB 94-1 itself cites some of the Department’s rulings over a number of years to support that thesis.<sup>28</sup> Also, a pension activist, declaring an interest in advancing ETIs, wrote a letter to Rep. Saxton which documented favorable statements by President Bush and other Republican officials, as well as by the prestigious Advisory Council on Pension and Welfare Benefit Plans of the Department of Labor serving during the Bush Administration.<sup>29</sup>

The cited statement by President Bush was given in response to a so-called Presidential Candidate Employee Benefit Questionnaire:

To the extent that socially motivated investments do not compromise the economic balance of risk and return to the plan and are consistent with other requirements, they are not improper. However, pension assets should not be used to subsidize investments that cannot stand on their own merits.

Saxton’s reply to the letter observed, as his only substantive demurrer, that “no other head of PWBA (the Pension and Welfare Benefit Administration within the Labor Department) — a regulatory and enforcement agency — has actively promoted ETIs, giving 11 major speeches on ETIs and many others partly on ETIs all around the country.”<sup>30</sup> Is that the Congressman’s real beef?

## VI. THE SAVING OF NEW YORK CITY

So it is not a new idea to use pensions to serve social ends. The original term for it, in fact, was “social investing,” as we have seen. In New York City’s dark days some twenty years ago, the City Administration turned to the municipal pension funds — of the police, firemen, and

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<sup>26</sup> *Id.*

<sup>27</sup> See Targeted Pension Fund Investments, 103d Cong., 2d Sess. (1994), noted in *Phone DOL*, *supra* note 10.

<sup>28</sup> IB 94-1, *supra* note 2.

<sup>29</sup> Letter from Sam Gilbert, delegate to the 1995 White House Conference on Small Business, to Representative Jim Saxton (May 11, 1995) (on file with the author).

<sup>30</sup> Letter from Representative Jim Saxton to Sam Gilbert (June 5, 1995) (on file with the author).

teachers — to meet the City's payroll, or, more accurately, to buy City bonds and thus provide money for the payroll. I know. I was in Washington then as an Assistant IRS Commissioner, in charge of the pension part of the Revenue Service, and it so happened that I had to approve or disapprove this use of pension money. It all depended on how I thought it fell within the pension qualification rules. Cities, too, must follow the rules.

But what makes the municipal pension plans of municipalities and other public sector funds distinctive is that they are outside the jurisdiction of the Labor Department; public sector plans do not contend with the "dual jurisdiction" bugaboo which confronts private pension plans, for they are not subject to the regulatory authority of the IRS or the DOL. In the past, that overlapping jurisdiction has produced contradictory rules, which raised the possibility that IRS might not subscribe to the philosophy of the Labor Department, as later expressed in IB 94-1, at least as applicable to public plans. (IB 94-1, of course, itself did not enter into the considerations of IRS in the New York City matter; it came almost 20 years later.)

In view of IRS' sole jurisdiction over public pension plans, potential conflict of agency views was not a factor in the resolution of the New York City issue. The IRS had no policy regarding social investing when it confronted the New York crisis in 1975, and it had scant time to formulate one if it would make a timely response to the City's request. Further, the agency's experiences were almost entirely in the private pension sector; they were of little precedential value in an issue involving pension plans of a sovereign government established, using the dollars taxpayers contributed because of the decrees of their elected representatives. Indeed, the plans themselves functioned in a highly political environment where even the plan trustees themselves held political office — or were, at least, indebted to elected officials for their positions as trustees. (The special factors at play in the public pension fund environment is a subject all to itself.<sup>31</sup> Alas, it was not yet written in 1975, when it might have been most useful to us.)

It was not an easy call for the IRS. There was nothing in the City's till then — not even the twenty-three dollars (adjusted for inflation) that the Dutch had paid to New York's original inhabitants over three hundred years ago. But in 1975, the banks would not lend the City another dime. Its credit rating had fallen through the floor. Washington did not want to help a profligate city that had squandered its funds on a free university and other generous social welfare programs. Indeed, the *New*

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<sup>31</sup> See, e.g., Roberta Romano, *The Politics of Public Pension Funds*, THE PUBLIC INTEREST, Spr. 1995, at 42; Beverly Ross Campbell & William Josephson, *Public Pension Trustees' Pursuit of Social Goals*, 24 J. URBAN & CONTEMP. LAW 43 (1983); Ford Report, *supra* note 3.

*York Daily News* summarized the President's attitude toward New York with the terse headline: "Ford to New York: 'Drop Dead.'" <sup>32</sup> There was, in fact, not enough money in the City's treasury even to satisfy the weekly payroll due on Friday, and already it was Wednesday. (Unbelievable as it now seems, the cash shortfall for the payroll was a mere \$130 million.) However unthinkable it was, bankruptcy for the City seemed imminent.

In this grim setting, a 20-hour marathon meeting occurred in the big conference room next to the Assistant Commissioner's office. The agenda was to give the City's representatives an opportunity to persuade the IRS to grant the City a pass to borrow from its pension funds without adequate interest and security. Such a loan was not just a possible imprudent investment and a potential breach of fiduciary duty, but probably also a "prohibited transaction" (as tax law dubs it <sup>33</sup>) which would have caused a loss of tax exemption. The loan could also have "disqualified" the pension plans if the IRS had found that the City had violated the exclusive benefit rule (I discuss it below). Dire tax consequences would have resulted, especially for the trustees themselves. <sup>34</sup> Chief among those possibilities was the violation of the most inviolable of the footings supporting the special tax status of pension plans: the requirement that no part of the pension trust be used for purposes "other than the exclusive benefit of plan participants," which include "all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries." <sup>35</sup>

During the course of the meeting, the IRS improvised a strategy to provide a temporary solution to keep the City going until Congress crafted and the President accepted a federal rescue package for New York. <sup>36</sup> The New York State legislature also pitched in with a statute

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<sup>32</sup> This, in fact, was the headline for the cover story of October 30, 1975.

<sup>33</sup> The current provisions governing prohibited transactions are in I.R.C. § 4975. ERISA added them. The provisions impose excise taxes on pension plans, but exclude governmental plans. See I.R.C. § 4975(g)(2). Section 503 contains its own definition of "prohibited transactions," and, unlike the ERISA provision which bars any loan between a plan and its sponsor unless a government agency action exempts it, section 503 only includes loans made "without the receipt of adequate security and a reasonable rate of interest." See § 503(b)(1). This statutory language was especially important in the IRS deliberations involving the New York City crisis.

<sup>34</sup> For plans which are outside the reach of the excise tax provisions of I.R.C. § 4975, such as a government plan, the effect of engaging in a prohibited transaction is loss of tax exemption. See I.R.C. § 503. Government plans, however, are of course not also subject to the excise tax, and do not lose their "qualified trust" status (with severe consequences for plan participants) unless they also violate the "exclusive benefit" and "antidiscrimination" requirements of the Code. One wonders, though, whether exemption from federal taxation of a government plan's pension trust is sustainable — despite its having engaged in a prohibited transaction — under the constitutional insulation of state and local instrumentalities.

<sup>35</sup> Treas. Reg. § 1.401-2(a)(3).

<sup>36</sup> P.L. 95-497, 92 Stat. 1665 (1978).

which, in effect, exonerated the City pension trustees from any potential violation of their fiduciary investment standards; the statute authorized the trustees to consider, "in addition to other appropriate factors recognized by law," the extent to which, by protecting the City fisc as the ultimate source of funds for participants' retirement benefits, the purchase of New York City paper might aid the City in fulfilling its obligations as a contributor to its retirement systems and as ultimate underwriter of the pension benefits.<sup>37</sup>

Details of the exchanges between the City and the IRS are now a matter of public record. So too are the novel "letters of intent to rule" that IRS devised to deal quickly with the situation, pending the composition of a rescue package in Washington and Albany.<sup>38</sup>

But do not think that IRS gave away the store in 1975. IRS did not acknowledge that it was relaxing the trustees' duty to invest retirement system assets in accordance with traditional standards of prudence. On the contrary, the Service predicated its action on an assumption it perhaps made too readily that all the safeguards of a prudent investment would accompany the pension plans' purchases of City securities. Thus, IRS meant to send an unequivocal message that it interpreted the exclusive-benefit rule as prohibiting, at a cost of less favorable tax status, anything less than a prudent investment, and that IRS would stand by its interpretation no less for public pension plans in crisis environments than for private pension plans in pursuit of conventional goals.

Actually, even after all the caution, the investment still landed the City's trustees in court in several landmark cases. (One retired teacher, in fact, even named me for my part in allegedly jeopardizing his pension.<sup>39</sup>) In the most notable of the decisions, the federal district and appeals courts in New York sanctioned the trustees for considering factors extraneous to — or at least only obliquely related to — the simple payment of pensions.<sup>40</sup> In a memorable passage, the trial court stated:

What determined the issue for the trustees was the specter of the City's bankruptcy, and, accordingly, the question becomes the extent to which this was a legitimate concern in the making of their investment decision.<sup>41</sup>

The court further noted:

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<sup>37</sup> 1975 NY Laws ch. 890, sec. 1(a).

<sup>38</sup> Campbell & Josephson, *supra* note 31, at 89, 101.

<sup>39</sup> See *Kirshner v. U.S., Sec. of Treas., Com'r of IRS*, Alvin D. Lurie, in his capacity as Ass't Com'r Employer (sic) Plans and Exempt Orgs. *et al.*, 603 F.2d 234 (2d Cir. 1978), *cert. den.* 442 U.S. 909 (1979), 444 U.S. 995 (1979), *on remand sub. nom.* *Kirshner v. Goldberg et al.*, 506 F. Supp. 454 (S.D.N.Y. 1981), *aff'd* 742 F.2d 1430 (2d Cir. 1983).

<sup>40</sup> *Withers v. Teachers' Retirement System*, 447 F.Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

<sup>41</sup> *Id.* at 1255.

[U]nder the unique circumstances presented — in which the survival of ‘the fund as an entity’ necessarily achieved prominence — the trustees’ investment decision was such as to fulfill their fiduciary obligations to the IRS.<sup>42</sup>

While not directly on point, these decisions would still have been helpful to the IRS in its deliberations; but the cases arose, of course, after the IRS needed to act.

It took extraordinary efforts from many quarters to access the City’s pension funds; and, as we saw even in the decisions above, it would not have happened if the trustees had not been faced with the absolutely unthinkable prospect that the biggest city in America would otherwise go bust and at the same time doom its pension plans anyway. Indeed, there was testimony in the cases that the trustees would not have purchased the City bonds but for this crisis. Hence, the New York crisis may not be much precedent for using pension funds generally to “rebuild America,” and even less so in view of the differences between public and private funds generally. Obviously, no one now suggests that America invest pension money in bankrupt entities. But the “inner city” warrens and pot-holed highways, which resemble Baghdad and Sarajevo more than Fifth Avenue and Main Street, do not occupy a significantly higher status on the “legal list” for trust investments.

At bottom, the experience with the New York City crisis may establish little more than the principle that extraordinary circumstances bring forth extraordinary remedies. This precedent, then, would justify, at most, the placing of pension funds in high-risk investments in order to achieve specific social ends in the most rare circumstances. The arbiters in the New York case — the regulatory agency and the courts — were, of course, aware of the dire consequences that might ensue all around from denying approval of the fiduciaries’ decision.

In the case of New York City, then, the indirect economic benefits went to the plan participants. Indeed, the benefits went to the pension trusts themselves. But would an even more indirect benefit — such as an investment in a neighborhood project that enhances the overall working environment of the participants — have been enough? Some observers answer “no,”<sup>43</sup> but some rulings suggest otherwise.<sup>44</sup>

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<sup>42</sup> *Id.* at 1259.

<sup>43</sup> Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 101 (1980); Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 PA. L. REV. 1340, 1363 (1980).

<sup>44</sup> See 49 Fed. Reg. 13,770 (1984); 50 Fed. Reg. 11,272 (1985); 58 Fed. Reg. 13,094, 13,096 (1993).

This is the basic underlying debate over IB 94-1: If there is no connection at all between the pension trust investment and the pension payments, can the trustees' predisposition towards a societal goal influence the investment decision so long as the societal goal does not diminish the participants' actual plan benefits in terms of investment return and asset security?

The 1975 New York City experience contrasts with an offering the New York City administration has been contemplating. Republican Mayor Rudolph Guiliani sees no evil in turning to pension trusts for municipal needs. His administration last year developed a novel plan to bundle city real estate tax liens for sale to a trust, which the city would create specifically as an investment vehicle for this program.<sup>45</sup> This investment trust would fund the purchase partly by borrowing from pension trusts and other institutional investors, and the arrangement would provide the lenders with over a dollar fifty of delinquent tax bills as collateral for every one dollar of loan. At that level of collateral, the lenders' risk would be "tiny" — in view of the investment bankers to whom the City circulated requests for bids. The interest cost, therefore, would be in the range investors associate with short-term commercial paper.

Now the City would again go to pension funds, as it did in 1975, to finance its budget. But there are many differences between a financially solvent city's borrowing from private pension plans, on the one hand, and a near-bankrupt city's tapping of its own municipal plans in 1975 as a last resort lender. Further, the price of the proposed tax-lien loans will have a competitive market rate of return and involve no subsidy from the city or concession from the investors. The transaction could serve as a model everywhere for ETI offerings of federal, state, and local authorities.

Can we properly characterize such investments as ETIs? And does it matter? Would our characterization depend on the motives of pension plan fiduciaries, if we could even discern them? Does the result turn on whether the issuer seeks out the investor or whether the investor seeks out the issuer? Just posing these questions answers them; for if nothing but the motive of the fiduciary in selecting the chosen investment distinguishes an ETI from a non-ETI, why should just a different motive be a badge of fiduciary dereliction?

If New York's sale of tax liens to private pension plans does occur, and if it attracts the attention of any pension regulators, they would not likely come from the IRS, as in 1975, but from the Labor Department (unless the City also offered the investment to its municipal pension

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<sup>45</sup> See David Cay Johnston, *New York City Plans Market in Its Tax Bills*, N.Y. TIMES, Jan. 13, 1996, at 35.

plans). The reason is that the city's connection with the transaction this time would be as the seller, not as pension plan sponsor, so DOL's jurisdiction would extend to both the purchasing pension plans and their fiduciaries. Given the existence of IB 94-1, DOL's intervention could be advantageous to New York.

## VII. A TALE OF TWO COUNTIES

Before we finish discussing the New York experience, we should note that the 1975 pension loans did not cause the loss of even a subway token. The New York City experience, however, contrasted with that of Orange County, California; there, a fling in derivatives by municipal funds turned out far less satisfactorily. We, of course, cannot conclude from that comparison that all ETI investments are sound and all derivative investments otherwise. Public opinion, however, and Congressional response often turn on one single calamitous event; Congress enacted ERISA, for example, on the momentum of its outrage over the Studebaker Company's pensioners' losing their benefits when the once powerful automobile company failed with greatly underfunded pension plans. Similarly, there would likely be strong, explicit anti-ETI laws now had the New York loans gone sour. But, on the other hand, nothing indicates that the Orange County debacle will result in new restrictive rules governing pension investments. What is the difference? Apparently, nothing but greed and naivete motivated the Orange County investments; and, besides being imprudent, the investments are not a violation of ERISA any more than the pension plan investments in the junk-bond annuities of Executive Life Insurance Company, besides being imprudent and evidence of self-dealing, were violations.<sup>46</sup>

We do not have to reenact the prudent man rule every time there is an imprudent trust investment. That rule well served the trust area for many decades, and it can now well protect pension plan participants against imprudent ETIs.

What, then, is there about ETIs that evokes such strong resistance? Calls for legislative remedy come equally from academics<sup>47</sup> and from politicians like Rep. Saxton, who would prohibit ETIs *per se* even absent specific evidence of abuse. Meanwhile, far more disastrous investment experiences attract no Congressional opposition. The difference is that, by definition, one enters into ETI transactions explicitly for a purpose "other than the exclusive benefit of plan participants," and to some ob-

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<sup>46</sup> For a discussion of the Executive Life fiasco, see Alvin D. Lurie, *Pensions Gone South: GICs cum Junk were Wrong Road to Travel*, 65 N.Y.St. B. J. 34 (1993). See generally, Alvin D. Lurie, *Mutual Benefit and Executive Life: The Lessons of the Two Biggest Life Insurance Failures Ever*, Program Materials of A.B.A. SEC. BUS. LAW (Ann. Meet. 1993).

<sup>47</sup> See *Phone DOL*, *supra* note 10, at 335, 355.



servers, that definition directly implicates the exclusive benefit rule. We now turn to this rule.

### VIII. EXCLUSIVITY: A CATEGORICAL IMPERATIVE

There is an overarching concern for plan fiduciaries — as great as being prudent and avoiding prohibited transactions. It derives from the proposition that we accumulate pension funds for only one thing: to provide for the secure retirement of workers. The first imperative of pension plans, and the most requisite prerequisite to their standing under ERISA and the tax law, is that they operate for the “exclusive benefit” of participants.<sup>48</sup>

Exclusivity, as it applies to pension plans, first surfaced in the tax law over fifty years before ERISA’s enactment. It was not a fiduciary concept (which tax law did not directly address), but an enforcer of the antidiscrimination principle which has always been the basis for favored tax entitlement.<sup>49</sup>

The concept also stems from the fiduciary duty of loyalty, which is one of the “most fundamental and distinctive” rules of private trust law.<sup>50</sup> ERISA, for unknown reasons, does not express this fiduciary command in terms of “loyalty”; it uses instead the tax law term “exclusive benefit.” But it is obvious that the thrust of ERISA is to impose the highest standards of fiduciary conduct on the persons handling pension funds — “the punctilio of an honor the most sensitive” was Cardozo’s great phrase.<sup>51</sup> This is the reason that the Act mandates the delivery of benefits in the trust format.<sup>52</sup> It then specifies fiduciary responsibilities; bars fiduciary self-dealing; absolutely prohibits all transactions in which fiduciaries or other parties in interest deal with plans, except as specifically exempted by statute or government action; provides for extensive legal and equitable recourse by participants, sponsors, and the government to enforce fiduciary standards; and even prohibits exculpatory provisions, all in addition to the exclusive benefit stricture.<sup>53</sup> Thus, while borrowing extensively from the common law of trusts, ERISA imposes responsibilities on trustees and other “fiduciaries” (a class under ERISA that includes much more than simply trustees<sup>54</sup>) that extend further than common law responsibilities in order to reflect the special nature and

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<sup>48</sup> See *supra* note 3.

<sup>49</sup> See Fischel & Langbein, *supra* note 15, at 1109; *Phone DOL*, *supra* note 10, at 342 nn. 33-34 (and accompanying text).

<sup>50</sup> Fischel & Langbein, *supra* note 15, at 1108.

<sup>51</sup> *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928).

<sup>52</sup> ERISA § 403(a). The statute also requires a written instrument providing for one or more named fiduciaries, in order to establish the plan. *Id.* § 402(a)(1).

<sup>53</sup> ERISA § 410(a).

<sup>54</sup> *Id.* § 3(21).

purposes of employee benefit plans.<sup>55</sup> So we can see “exclusive benefit” more as belt and suspenders than bedrock.

It was therefore unfortunate that in the pension area the draftsmen employed the concept of exclusive benefit as a surrogate for the fiduciary’s traditional duty of loyalty. This drafting, in fact, may be responsible for much of the mischief in this area of the law.<sup>56</sup> The concept might serve well in private trusts where the trustee’s relationship to the *cestui que trust* is often simpler; but in the setting of the pension trust, it fails to take into account that such an arrangement is the embodiment of a complex set of relationships and myriad interests: between employer and employees, for example, or among different employers in a multiemployer plan; between different classes of employees (younger and older, rank-and-file and management, shareholder employees and others, collective bargaining groups and non-union, contributory and non-contributory, long-term and short-term); between active and retired workers; and even between private pension plans themselves and the government guarantor of pensions, the Pension Benefit Guaranty Corporation. In this context, the term “exclusive” serves as little purpose as commenting that the President of the United States must serve all the people exclusively.

Further, the rule literally applies to all tax-qualified and other so-called pension plans equally; but there is no single type of “pension” plan, and not all plans are designed to provide retirement benefits. For example, just a deferral of benefits for “a fixed number of years” — as few as two — fulfills the requirements of a tax qualified profit-sharing plan.<sup>57</sup> So the term “benefit” provides an unsatisfactory standard for such a disparate group, for what “benefits” the participants of a true retirement plan is not what may benefit the participants of a plan which defers compensation for a short term of years. Similarly, we should not compare the benefits in a defined contribution plan with those in a defined benefit plan, any more than we should compare salary reduction plan benefits (the so-called 401(k) plans)<sup>58</sup> with employer-pay-all plan benefits.

How, then, can we observe the exclusive benefit obligation from plan to plan, and how can we parse it among different benefit groups within a single plan? The concept is obviously an imperfect — indeed, crude — instrument for such microsurgical cuts. Accordingly, in the face of this, courts have developed, *inter alia*, the “incidental benefit”

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<sup>55</sup> See Fischel & Langbein, *supra* note 15, at 1113-19.

<sup>56</sup> *Id.* at 1110, 1128.

<sup>57</sup> See Treas. Reg. § 1.401-1(b)(ii); Rev. Rul. 71-295, 1971-2 CB 184; and see Rev. Rul. 68-24, 1968-1 CB 150 (2-year deferral not necessary after 60 months of participation).

<sup>58</sup> I.R.C. § 401(k).

principle<sup>59</sup> to overcome what would otherwise be an insurmountable barrier.<sup>60</sup>

"Exclusive benefit" is, on its face, a misleading principle. Its meaning has eluded cloistered academics, politicians who are running for office, and even jurists with life tenure. The principle makes sense only where a conflict of interest arises between plan participants and others. In this circumstance, the rule compels that *only* the participants' interests matter. No one else's interests balance the scale. On the other hand, if there is *no sacrifice* of participants' interests, concurrently serving the interests of nonparticipants cannot flout the exclusivity principle.

This view of the proper function of "exclusive benefit" emerges clearly when we recognize that the principle derives from the private trust law duty of loyalty. The Uniform Prudent Investor Act states that "loyalty" compels the trustee to "invest and manage the trust assets solely in the interest of the beneficiaries."<sup>61</sup> The comment of the draftsmen explaining this rule is instructive:

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person." . . . No form of so-called "social investing" is consistent with the duty of loyalty *if the investment activity entails sacrificing the interests of trust beneficiaries*—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.<sup>62</sup>

Exclusivity, then, does not require that no other entity shall benefit from an investment; it merely requires that the other can neither rival nor compromise the chief purpose of the investment, which is to protect workers during their retirement. Thus, even the worthwhile goal of saving a business and, consequently, saving the pension participants' jobs must be subordinate to the purpose of providing a pension.

*A fortiori*, improving the economy, national or local, or improving the roads, or rails, or the clean air — whatever might be the community's goals, and no matter how lofty, worthy, and patriotic these goals are — cannot supersede the primary purpose of all pension plans and, obviously, cannot justify an investment that might jeopardize their delivery.

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<sup>59</sup> See *Donovan v. Bierwith*, 680 F.2d 263 (2d Cir. 1982).

<sup>60</sup> See Fischel & Langbein, *supra* note 15, at 1137.

<sup>61</sup> Uniform Prudent Investor Act [hereinafter UPIA] § 5 (explanatory comment under that section).

<sup>62</sup> *Id.* (emphasis added).

From the perspective of the plan trustees, better the bridges stay unrepaired than the pension promises be broken. One cannot quarrel with that position.

I would not even suggest that improving the economy is a proper consideration for pension trustees whatever the benefit to plan participants. Still, pension plans do not exist in a vacuum. They depend upon a healthy business climate.

Nevertheless, most impartial observers would agree that the command of the exclusive benefit rule refers to only the specific participants' *plan benefits*, not their benefits as members of the larger community.<sup>63</sup> While we can argue that the "benefit" ERISA identifies allows a broad reading, support for the ETI would be shaky if it depended on that argument alone. As I have suggested, the better argument is that the exclusive benefit rule is not incompatible with — in fact, does not even address — the employment of investment criteria which do not compromise in any way the interest of plan participants and beneficiaries.

We can even take one more step and argue that the exclusive benefit principle does not apply at all to certain parties: parties the plan deals with at arms' length when conducting the business of the plan (fiduciaries and parties-in-interest aside); the landlord, the vendor, the employee, indeed, all parties who derive benefit from the respective transactions. In the same way, the company whose stock the plan purchases at fair market value, although obviously benefiting from the plan investment, is not within the reach of the rule, regardless of why the fiduciaries chose to invest in that company. It follows, then, that the exclusive benefit rule does not affect a non-concessionary ETI.

## IX. A NEW PARADIGM FOR PENSION PLANS

I submit that a more fundamental assault on the exclusive benefit principle is appropriate. The exclusive benefit principle was drafted for a different stage of pension development, when the plans had not yet accumulated the trillions of dollars they now hold (*40 percent* of the Nation's capital). It was when we perceived only dimly the role of pensions in the state of our society, when the concept of "tax expenditures" had not yet been enunciated (certainly not in the context of pension plans),<sup>64</sup> when

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<sup>63</sup> See Hutchinson & Cole, *supra* note 43, at 1370-1371 n. 151; DISINVESTMENT, *supra* note 10, at 17-18.

<sup>64</sup> See generally, Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax*, 13 VA. TAX REV. 591 (1994). The following pieces indicate the passionate debate in academic circles over whether the term "tax expenditure" properly applies to a scheme for taxing pensions: Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 NO. CAR. L. REV. 315 (1988); Norman P. Stein, *Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky*, 9 AM. J. TAX POL'Y 225 (1991); Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder*

government guaranties of pensions did not exist, when the law that governed rights and interests of the various parties was more primitive, when the plans themselves were much simpler, and when Capital Hill thought more simplistically about them.

Perhaps now is the time for Congress to formulate a new paradigm for governing pension plans. This paradigm would better comprehend, accommodate, and balance the many different interests involved, including the interests of government. Given this multiplicity of interested parties, benefits, and social policies which intersect at the modern pension plan, the structure is much like a public corporation with competing and conflicting claims upon it.

Let us consider the public corporation. Its management, like the management of a pension plan, bears actual *fiduciary* responsibilities and a duty of primary loyalty to its principal constituency. In the former, the constituency is the stockholders, and in the latter, it is the pensioners. Nevertheless, we are long past the point where the directors and officers of a corporation must ignore the interests of their communities or of their employees: preventing pollution, providing support for the local arts, establishing day care facilities for their employees.

In an op-ed piece this past January, Secretary Reich reminded us of the words of the chairman of Standard Oil in 1951:

The job of management is to maintain an equitable and working balance among the claims of the various directly interested groups . . . stockholders, employees, customers and the public at large.<sup>65</sup>

As the Secretary's column points out, even Fortune Magazine agreed that corporate executives had the "duty to be industrial statesmen who worked for the good of their employees and communities as well as shareholders."<sup>66</sup>

It took the 1932 seminal work of Berle and Means on the modern corporation<sup>67</sup> to change the way we view corporate ownership and management. Indeed, before 1932, we did not label the two as "divorced"<sup>68</sup>

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to Professor Stein, 9 AM. J. TAX POL'Y 257. And if I entered this law review war, my piece would read in its entirety (title and all):

*A Riposte to the Above*

What about counting the negative tax expenditures occurring when pensions are in pay status, sometimes producing rates at or near the 100% bracket when toting up federal and state income, excise and estate taxes? Fiscal budgeting to the contrary notwithstanding, there is a tomorrow.

<sup>65</sup> Robert B. Reich, *How to Avoid These Layoffs?*, N.Y. TIMES, Jan. 4, 1996, at A21.

<sup>66</sup> *Id.*

<sup>67</sup> BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932; rev. ed. 1967).

<sup>68</sup> *See id.* (preface to 1932 ed.).

or acknowledge the obligation the modern corporation had to the interests of the state due to the "state expenditures of taxpayers' money" on behalf of corporations.<sup>69</sup> The parallels to pension plans are striking. It might take just such a rigorous examination of the modern pension plan to bring us to a new similar understanding of the interests the pension fiduciary can take into account. The beginnings of this examination, in fact, may already exist; in the writings of Fischel and Langbein<sup>70</sup> we find remarkable insights:

Because . . . the employer and the employee both benefit from the pension or welfare benefit plan, there is an obvious difficulty in interpreting the exclusive benefit rule. The plans are established for the mutual advantage of employer and employee, not for the exclusive benefit of one. The exclusive benefit rule on its face is inconsistent with the economic realities of the plans.<sup>71</sup>

. . . .

[I]f fiduciaries and courts were directed to identify and weigh all the relevant interests, they would be better able to maximize the interests of all the parties. In a world of voluntary plan formation, if the contracting parties understood that the legal standards for evaluating plan decisionmaking had become more realistic and more reasonable, they would be more likely to form plans and to establish higher levels of pension saving.<sup>72</sup>

. . . .

The confusion between . . . perspectives is . . . evident in the requirement that trustees must act with an "eye single to the interests of the participants and beneficiaries." The difficulty with this requirement is that it begs the question of who the beneficiaries are. If the employer were also understood to be a beneficiary from the ex ante perspective, the dual loyalty problem would be greatly reduced.<sup>73</sup>

The authors recognize that other potential conflicts of interest besides employer-participant differences inhere in the pension environment:

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<sup>69</sup> See *id.* at xvi (Professor Berle's preface to rev. ed.).

<sup>70</sup> In a separate work, Professor Langbein discussed the separation of ownership and control that characterizes large pension funds. In the context of social investing, he argues that the practice is a "danger" to participants. *DISINVESTMENT*, *supra* note 10, at 8.

<sup>71</sup> Fischel & Langbein, *supra* note 15, at 1118.

<sup>72</sup> *Id.* at 1125.

<sup>73</sup> *Id.* at 1128.

The language of the exclusive benefit rule speaks in the plural. It stipulates that a duty of loyalty is owed to "participants and their beneficiaries." It does not assume, as it could not logically assume, that all participants and their beneficiaries will always have the same interests.<sup>74</sup>

[S]ome mechanism must exist for resolving conflicts among employees, even when the statute overlooks the problem.<sup>75</sup>

In *Donovan v. Walton*,<sup>76</sup> the Florida federal district court dealt with a multiemployer plan which invested pension assets for the purpose, in part, of creating jobs for union members and thereby benefiting the union directly. After noting that there were, in fact, parallel benefits for the union and the pension fund, the court concluded that "[e]ven without these benefits to the Fund," the exclusive benefit rule "simply does not prohibit a party other than a plan's participants and beneficiaries from benefiting in some measure from a prudent transaction with the plan."<sup>77</sup>

The case for providing social benefits through pension funds is not difficult to make when the public interest benefits. The public fisc, after all, makes substantial contributions for the establishment and maintenance of tax qualified pension plans. There are also the public contributions to the corporate sponsors of such plans, upon which Professor Berle posited much of his view of the role of "modern" corporate management.<sup>78</sup>

A rule of law would easily develop if the two regulatory agencies which enforce pension law made it clear that social investing is not a *per se* violation of the exclusive benefit principle or of the other legal standards which protect pensioners. This is just what DOL tried to do with IB 94-1. Courts could then defer readily to such administrative rule-making, as they customarily do.

What is the administrative posture at this time? The IRS has not yet spoken directly on the matter, so we can only infer its views from such incidents as the New York City crisis, which, as we have seen, may be of limited value in creating a new principle for private plans. The IB 94-1 issue might arise in matters under IRS jurisdiction, but, as far as we can glean from the public prints, the Service has not currently expressed its concurrence with the DOL's view.

<sup>74</sup> *Id.* at 1159.

<sup>75</sup> *Id.*

<sup>76</sup> 609 F. Supp. 1221 (S.D. Fla. 1985), *aff'd per cur. sub nom. Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986), *reh. den.*, 802 F.2d 1399 (1986).

<sup>77</sup> 609 F. Supp. at 1245

<sup>78</sup> See text *supra* accompanying notes 67-69.

We must also be cautious when we try to read DOL's current official position. As long as H.R. 1594 sits out there in the legislative hopper, we can assume that it may be exerting an *in terrorem* effect on DOL's readiness to act on its Interpretive Bulletin. Moreover, the Department may be hesitating because of the possibility of a new occupant in the White House on January 1, 1997.

#### X. THE ORIGIN OF DOL'S CURRENT POSITION

Long before the arrival of the Clinton appointees, the Labor Department identified the participants' interest in their retirement income as the only "interest" that pension investments serve. These are the actual words of the Department, in a so-called advisory opinion:

In deciding whether and to what extent to invest in a particular investment a fiduciary must consider only factors relating to the interests of plan participants and beneficiaries in their retirement income.<sup>79</sup>

The opinion continued:

Thus a decision to make an investment may not be influenced, for example, by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the fund.<sup>80</sup>

We can find the antecedent for this "equal or superior" investment option in comments a former head of pension administration in the Department of Labor made some years before that pronouncement. Writing as an official, but not *ex cathedra*, the pension head said that while the protection of retirement income is "the overriding social objective governing the investment of plan assets," that overriding social objective "does not exclude the provision of incidental benefits to others."<sup>81</sup> Rather, the plan trustee still can choose among "economically equal but socially unequal investments."<sup>82</sup>

When he spoke about relying on the "incidental benefit" concept, that official obviously did not mean to indicate the absence of a deliberate choice. Instead, he meant to coat social investing with the cloak of a time-honored doctrine. He was not saying that the social benefit must unintentionally occur, but that it could be a significant factor in an in-

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<sup>79</sup> DOL Advisory Op. 82-52A (Sept. 28, 1982)

<sup>80</sup> *Id.*

<sup>81</sup> See Ian Lanoff, *The Sound Investment of Private Pension Plan Assets: May it be Done Lawfully under ERISA?*, 31 LABOR L. J. 387, 389 (1980).

<sup>82</sup> *Id.*



vestment decision. However, this was not an official pronouncement on which fiduciaries could safely rely.

So it remained for the proposition to be made official that it is no sin to favor an investment that results in a social benefit, and that the trustees do not have to conceal their awareness of the social benefit and disclaim that it greatly influenced their choosing the investment. That is what the New York City Bar Association committee was asking for in the report I cited above, and, presumably, that is what DOL intended IB 94-1 to accomplish. But the status of that interpretive bulletin is now problematic.

Unfortunately, the rulings DOL made before issuing IB 94-1 have sent mixed signals. In one, the trustees applied the appropriate economic criteria and financial standards in soliciting plan investments, but they invested only where there was union labor. The Department nevertheless approved the use of these dual criteria on the condition that the policy must not diminish the choice of investments that would be available otherwise.<sup>83</sup>

Another ruling, however, legal commentators have read as approving the consideration of social criteria only as secondary factors. In that case, the trustees elected the investments of a particular class (real estate) on purely economic and financial considerations, but then the trustees further screened the investments so that only union labor projects made the final cut.<sup>84</sup> Perhaps the difference between the two rulings is simply cosmetic. It would always be possible to couch the policy in "primary" and "secondary" terms. But it should not be necessary.

In still another pair of rulings,<sup>85</sup> a body that had only investment *advisory* authority screened the preferred investments (housing loans in communities where union members resided and debt instruments of health and education institutions serving those communities), but the investment managers still exercised independent fiduciary judgment. The potential for the managers paying lip service to this independence, while in practice following the "advice" of the investment advisers, makes this also an unsatisfactory, if not hypocritical, standard.

Again the Department harkened back to the "equal or superior" standard. It stated in the later of those letter rulings:

A decision to make an investment may not be influenced by non-economic factors unless the investment, when judged solely on the basis of its economic value to the

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<sup>83</sup> DOL Letter to James S. Ray, Jul. 8, 1988 (relating to Union Labor Life Ins. Co.) (on file with author). IB 94-1 cites this letter with apparent approval. See *supra* note 2.

<sup>84</sup> DOL Advisory Op. 82-52A, *supra* note 79, and accompanying text.

<sup>85</sup> DOL Advisory Ops. 80-33A (June 3, 1980) and 88-16A (Dec. 19, 1988).

plan, would be equal or superior to alternative investments available to the plan.<sup>86</sup>

It is obviously easier to make the case for a targeted investment policy where the target has a direct connection with the well-being of the plan participants — as in the case of affordable housing, better schools in the community, or even the economic health of the company or industry for which the participants work. But even there, at least until IB 94-1, the government has not clearly enunciated a policy that such an investment strategy squares with ERISA's "solely-in-the interest-of" mandate.

*Morse v. Stanley* is another case which involved not investment policy, but the trustees' exercise of discretion: They decided whether to give accelerated lump-sum pension benefits to participants who left their employer to work for a competitor. This time the court viewed expansively the factors which trustees can consider while still serving "solely the interests" of plan participants:

Where an employee leaves a company to accept a position *outside* the industry, that company's profits are affected by the costs it must incur to groom a replacement; but if that same employee accepts a position within the *same* industry and with a direct competitor, not only must the first company bear the costs of grooming a replacement, but it suffers additional detriment from the competitor's use of that employee's talents and contacts. This is especially so here, where profitable accounts were actually transferred to a competitor. Hence, since an exodus of key . . . employees plainly reduces the growth and fiscal strength of the Plan, the Trustees' decision to deny accelerated benefits to the employees here could scarcely be viewed as a breach of their duty to administer the Plan in the sole interest of all its participants.<sup>87</sup>

The holding in that case, however, rests on the direct connection between the trustees' action, the economic health of the plan, and the job security of the participants. As we have already observed, where the social benefits of the investment less directly affect — or affect less significantly — the interests of the participants, it may be harder for the trustees to defend their decision. Nevertheless, it is obvious that the Labor Department's advisory group on ETIs is sympathetic to the more expansive view and has even supported the Labor Department's current leanings. In its report to the Labor Department, the group wrote:

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<sup>86</sup> DOL Advisory Ops. 80-33A, *supra* note 85.

<sup>87</sup> *Morse v. Stanley*, 732 F.2d 1139, 1146 (2d Cir. 1984).

As long as trustees are loyal to participants and invest for their exclusive benefit, they should be free to seek investments which generate economic benefits for their region or industry. To the extent that their search for (or willingness to examine) non-traditional investments overcomes subtle rigidities in our capital markets and results in financing worthy investments which might otherwise not be funded, it benefits society as well as their plan participants.<sup>88</sup>

The problem is that such an investment yardstick may flout the both "exclusive benefit" and "solely in the interest" tests which pertain to pension investments. At least, this is what the fiduciaries generally believe. The only thing that would make fiduciaries comfortable when considering such alternative investments would be the Department's ruling on a series of fact patterns which illustrate the economically-equal but socially-unequal proposition (we are assuming, of course, that the Saxton bill does not become law). But even these rulings might not be sufficient, for the Labor Department is not the sole enforcer of trustee liability. The IRS is also a player, of course, and plan participants have direct recourse to the courts as well.

## XI. FEDERAL LEGISLATION?

Federal legislation would clarify the rules in one fell swoop. This legislation would be 180 degrees off the course of the Saxton bill and share the purpose of the Seventies New York legislature when it expressly allowed fiduciaries to consider "social . . . in addition to other appropriate factors."<sup>89</sup> Such enabling legislation should include at least these five guideposts to assure that trustees engage in the proper drill: (1) looking solely at economic merits, the investment is suitable for the plan; (2) the purpose of the investment is to provide for the participants' plan benefits; (3) the social benefit, while not necessarily subordinate to the other primary purpose of the investment, does not in any way compromise that purpose; (4) the trustees clearly identify the social benefit; (5) the targeted investment does not thwart, in any reasonably foreseeable way, the participants' receiving their plan benefits.

Thus, if the trustees can make the investment with due regard to providing participants' plan benefits, and if the trustees in no way had subordinated their primary obligation to other interests, their actions would then satisfy ERISA's "solely in the interest of participants" standard. Under the legislation, then, trustees would not have to "explain

<sup>88</sup> See Executive Summary in DOL ADVISORY REPORT, *supra* note 6.

<sup>89</sup> See text accompanying note 37.

away" the social benefits which flow naturally from a targeted investment. But it would not, of course, sanction benefits which serve the interests — personal, professional, or political — of the trustees themselves.

The legislation would also make it possible to devise a method for protecting pensions while enabling plan trustees to frankly make investments which serve the welfare of the nation, the community, the industry — any legitimate object of social concern. It then becomes just a matter of the trustees choosing carefully when to make these socially-concerned investments. If the trustees can still demonstrate a sound and appropriate underlying purpose for these investments — an underlying principle that is relevant to the pension participants — the investment need not cause the trustees or their plans to suffer legal sanctions.

Administrative action or judicial decision can achieve this outcome (barring enactment of the Saxton bill), but only federal legislation can make it certain. More exactly, *federal* legislation must do the job because of the federal preemption rule. As we have already seen, New York State legislation was critical to the New York City bailout; and the states and municipalities are naturally tempted to induce and sometimes even command public pension plans under their jurisdictions to invest in local infrastructure, industry, environment. State legislation works there because ERISA preemption is not applicable to the public sector plans. Were state legislatures, however, not to limit legislation to public pension funds, it is doubtful that the legislation could withstand a preemption challenge, so central is fiduciary liability and authority to ERISA.

Federal preemption of issues arising under ERISA is a growing area of the law, and the Supreme Court is repeatedly umpiring disputes. In the recent *Travelers* case, for example, the Supreme Court refused to strike down a state tax impacting generally on hospital and medical plans which ERISA governs. The case had some commenting that the court significantly narrowed the ERISA preemption doctrine. The Labor Department, in fact, has indicated that it will attempt to build upon the decision in order to facilitate plan participants' use of state law to achieve relief that federal law might not offer.<sup>90</sup> But *Travelers* seems to be only a modest departure from the trend of enlarging the reach of preemption, in strictly limiting ERISA's preemption to state laws that "relate to" employee benefit plans.

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<sup>90</sup> New York State Conference of Blue Cross and Blue Shield Plans v. Travelers Insur. Co., 514 U.S. \_\_\_ (1995), 131 L. Ed. 2d 695 (1995). See Mamorsky, *Impact of Traveler on Self-Insured Plans*, 11 J. COMP. & BEN. No. 2, 57 (1995). For discussion of recent DOL initiatives to limit ERISA's preemptive reach in the wake of *Travelers*, see R.I.A. PENSION & BENEFIT News, Jan. 22, 1996, at 2.

Regarding core ERISA issues, we cannot doubt that federal preemption will prevail. Thus, effective federal legislation is needed if there is to be any clear resolution of the ETI issue in the near future. But getting the House of Representatives, in effect, to reverse itself on the ETI issue may be an unrealistic goal, at least so long as it remains in Republican hands.

## XII. DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS: SAME GENUS, DIFFERENT SPECIES

All of pensiondom is divided into two parts: defined benefit plans and defined contribution plans. These terms refer to, respectively: (i) plans where the benefit is fixed, i.e., traditional annuity-type plans; and (ii) plans where the contribution is fixed, as in money purchase, 401(k), and profit-sharing plans. (In actuality, there are hybrid plans which have both characteristics, but identifying these subsets in this discussion is not necessary.)

Considering the substantial difference between these two main categories of pensions — especially regarding participants' direct stake in the success or failure of their investments — we cannot discuss ETIs and pensions as if all types of pension plans were just one species. To the participant, the chief difference is that in the former type of plan, the risk of the investment falls on the employer and, as a last-resort guarantor, the Pension Benefit Guaranty Corporation. Thus, only a residual risk remains on the participant if there still is a shortfall after tapping the employer and the PBGC. In the defined contribution plan, on the other hand, the participant directly bears the investment risk, and this difference affects plan fiduciaries' receptivity to ETIs. But it does not eliminate the fiduciary's concerns in defined benefit plans because the standards of prudence, exclusivity, and sole interest apply uniformly to both classes of plans.

Nevertheless, where the employer is, in effect, the guarantor of the plan benefits, and where the employer or its designee serves as trustee — typically this is the case with public pension funds — we see more ETIs as a percentage of plan assets. Fiduciaries are understandably less eager to place a participant's own account in a nontraditional investment without the participant's having clearly designated a choice. But even the use of participant-directed accounts does not insulate the fiduciary against offering poor-grade investment options.<sup>91</sup>

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<sup>91</sup> See ERISA § 404(c); 57 Fed. Reg. 46,906 (1992) (codified at 29 C.F.R. § 2550.404c-1). The regulations specify in great detail what the plan must do by way of offering "a broad range of investment options," *inter alia*, in order to achieve insulation.

The participant, in fact, is under legal constraints that prevent directing the trustee to invest in the investments the participant has selected. Presumably in recognition of these legal constraints, last year's White House Conference on Small Business adopted a recommendation that would "[m]odify current legislation to facilitate the ability of an individual to invest up to 50% of his or her own self-directed and/or managed qualified plans including profit sharing, 401(k) plans, individual IRAs, Keogh, and SEP plans in specific small business[es] of his/her own choice."<sup>92</sup> Presumably, such legislation would enable the trustee, with impunity, to offer participants the opportunity to individually designate preferred ETIs under proper safeguards.

Thus, the issues affecting whether to invest in ETIs are not much different for the fiduciaries of a defined benefit plan and for the fiduciaries of a defined contribution plan. The principal reason that public pension trusts use more ETIs (although public pension trusts still represent a minor portion of total funds) is doubtless the political influences that can affect the investment decisions of such plans.<sup>93</sup> In several visible instances, the disastrous consequences of these pressures has been documented:<sup>94</sup> losses of millions of dollars which public employee pension plans suffered in Alaska, Connecticut, and Kansas, for example. Those consequences, of course, are factors one must take into account when advocating an unfettered ETI policy. Nevertheless, they are considerations peculiar to the public plans; they should not influence the debate generally.

Legislation such as the Saxton bill, however, does not address that problem, for the public pension funds are, as we already noted, completely beyond the jurisdiction of the Labor Department. Because tax rules, on the other hand, generally apply equally to *all* pension plans and participants, only the Internal Revenue Service and the Treasury Department are in a position to influence investment policy in that area. The chances of the House Ways and Means Committee approving the Saxton bill — if the legislation were even amended to embrace the Internal Revenue Code or the provisions of ERISA bearing on the Code — borders on zero. And then there is the Senate Finance Committee.

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<sup>92</sup> See Recommendations of 1995 White House Conference on Small Business [hereinafter "WHCSB"], Reference No. 5. A copy of the so-called "Final 60 Recommendations" is on file with the author.

<sup>93</sup> See Romano, *supra* note 31; Ford Report, *supra* note 3; REPORT OF U.S. GEN. ACC'G OFF., PUBLIC PENSION PLANS — EVALUATION OF ECONOMICALLY TARGETED INVESTMENT PROGRAMS, GAO/PEMD 95-13 (Mar. 1995) (demonstrating that relatively little public pension money has been directed into ETIs, despite political pressures on public plan fiduciaries) [hereinafter "GAO Report"]. See text accompanying notes 104-106 *infra*.

<sup>94</sup> See, e.g., GAO report, *supra* note 93, at 22-23.

## XIII. CAPITAL FOR SMALL BUSINESS

This paper focuses on investments which serve, for example, the welfare of cities and states. IB 94-1 also includes small business investments within the classes of investments it covers, because small businesses do not have access to the capital of big business. In this respect, the Interpretive Bulletin anticipated recommendations of the 1995 White House Conference on Small Business. High on the list that Conference adopted was Recommendation No. 5:

In order to increase the availability of capital for small business, Congress shall:

a) Authorize the SEC or an appropriate entity to create or streamline regulations and vehicles for public and small and large private company pensions, profit sharing, 401(k) plans, individual IRAs, Keogh, and SEP plans to invest in small business by accessing the private capital markets and encouraging development of viable markets for small business loans.<sup>95</sup>

It is surely no accident that Recommendation No. 5 refers to "vehicles . . . to invest in small business." The draftsmen obviously knew that because of cost, economy of scale, research skills, risk, and availability of information, individual pension plans were less likely to make direct investments than to acquire interests in pooled funds with other individual pension plans. Moreover, such pooled funds would, in turn, not invest in just a single small business, but rather seek to gain the efficiencies, economies, safeties, and diversification of scale that come with investments in a balanced group of businesses.

It is important, however, to recognize that while such factors might affect the prudence of an investment program by lowering the cost and risk to an individual pension plan, they do not otherwise bear on the basic issue of this paper. Risk is an important element of any investment, but risk *per se* is not a bar. The DOL regulations state explicitly that "the relative riskiness of a specific investment . . . does not render such investment . . . either *per se* prudent or *per se* imprudent."<sup>96</sup>

Under current standards, trustees do not have to justify why they have chosen to invest in, say, a mutual fund rather than an individual stock. Whatever biases may have influenced the particular investment, it is sufficient simply to demonstrate its fitness (that is, its investment soundness for the particular plan), which means matching the investment to the unique combination of needs of the pension plan — cash flow,

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<sup>95</sup> *Supra* note 92, Reference No. 5, ¶ (a).

<sup>96</sup> 29 C.F.R. § 2550.404a-1 (1979). *See also* text accompanying note 24.

interest return, and maturity of benefit claims. Authorizing targeted investments which still fulfill such plan needs completely would not lessen the trustees' duty in any way.

Why should an investment in, say, Hong Kong, which anticipates the better economy when China reestablishes its sovereignty in 1997, be outside of regulatory inquiry (prudence apart), while an investment in a Detroit autoparts manufacturer with the object of reestablishing America's primacy in the international automobile market, or an investment in a start-up company to help it bring to market a promising invention, with resultant benefits to its community, be *per se* prohibited irrespective of its prudence? Not only does such a policy make no sense; it is not enforceable. If the government could punish a trustee for its *mens rea*, that fiduciary will no doubt leave no traces of its mental processes and force regulators to plumb that obscure terrain.

#### XIV. INCENTIVES FOR SUBSIDIZED INVESTMENTS

Can the government devise incentives to induce subsidized community investing? Or to direct plan investments towards particular projects, where the risk/reward ratios are not otherwise "equal or superior" to non-targeted investments? A plank of the Democratic Platform for the 1992 election advocated "the flow of investment to inner-city development and housing through targeted enterprise zones and incentives for private and public pension funds to invest in urban and rural projects." News accounts early in the Clinton Administration suggested that the successful Democratic Party was now considering this approach, although later statements by Clintonites withdrew the implication, by emphasizing that pension plans should always look for "the same risk/return of comparable good investments elsewhere in the economy."<sup>97</sup> The later statements may have been just punting with the goalposts at their backs.

In his remarks to the trade group,<sup>98</sup> Secretary Reich seemed to imply that quantifying the psychic returns that come to participants when they know they are helping society can offset any economic deficiencies of a targeted investment. This is not a good suggestion. No one can devise a satisfactory method for assigning "points" to an investment to compensate for the loss of a market rate of return — any more than a formula exists for fixing the fair market value of an investment on any given day. Only the market has that role.

But what is wrong with providing incentive to make investments that do not meet the demands of a neutral market place if the pension funds are in some way made whole? A 1993 recommendation of a Con-

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<sup>97</sup> B.N.A DAILY EXECUTIVE REP., Mar. 29, 1993, at A-5.

<sup>98</sup> See *supra* note 5 and accompanying text.



gressionally chartered body, the Infrastructure Investment Commission, would establish a government-sponsored corporation, the National Infrastructure Corp., to attract millions of dollars of investments from pension funds. It would accomplish its goal by offering insurance protection in some cases. In other cases it would offer federally guaranteed loans.

Another approach is the bill which Rep. DeLauro (D-Conn.) introduced in 1994. H.R. 5210 would create public benefit "infrastructure bonds"; pension funds purchasing these bonds could pass through the return on the bonds tax-free. Still others have suggested "financial engineering" to create sound pension investments through partnerships with other interested parties who have greater capacity to absorb risks and who lack the fiduciary constraints of pension trustees. These partnerships already occur, for example, when banks make "mezzanine" loans to large borrowers. Public guaranties of plan benefits which ETI investments lose (separate from the scheme of guaranties which PBGC now provides<sup>99</sup>) is another alternative, although we still remember the savings and loan bailouts too vividly to seriously consider it.

A different approach would be enacting measures of special relief for the trustees considering making targeted investments. This relief could simplify the administration of plans, as well as free plan sponsors from the stringent computational and other testing methodology — as well as from the penalties which result from inadvertent noncompliance with other rules. Small business especially would find this freedom appealing. Further, such an approach would be a step towards simplifying ERISA. Many have paid lip service to this goal, but only this year, with enactment of the Small Business Job Protection Act,<sup>100</sup> has there been even a modest movement in that direction.

The kinds of potential incentives are legion. In his op-ed piece, Secretary Reich suggested some which might be used to induce corporations to act socially responsible and held out as a carrot reducing or even eliminating corporate income taxes for the companies that do. Then he went past inducements and brandished a club; he suggested that the benefits of incorporation should be withheld from companies acting irresponsibly. Nothing so radical is necessary to induce ETI investments.

Whatever the nature of the incentives, they must not prove too irresistible and deliberately tempt trustees into an investment that is contrary to the interests of plan participants. The New York City experience tests the proposition. There the state legislature consciously induced high-risk investments by authorizing the plan trustees to consider the failing city finances, and even Congress added inducements in its rescue package.

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<sup>99</sup> See ERISA Tit. IV.

<sup>100</sup> P.L. 104-188, 110 Stat. 1755 (1996).

Arguably, such a case would not fit within the “economically-equal, socially-unequal” formula. What the federal and New York legislatures were attempting to do — and succeeded in doing, according to the federal court — was to *insulate the trustees* and thus induce them to make an investment which the trustees contended they would not otherwise have made. But we must recall that in the New York crisis there was a very strong nexus between the targeted investment and the preservation of the plans themselves. In those perilous days, many believed that without the loans from the plans, the municipal employees would lose both their pensions and their livelihoods.

If, however, incentives are to be provided, they should merely assure the payment of plan benefits in somewhat marginal cases, *not* personal assurances for the trustees when they make patently improvident investments. It will not be easy — perhaps impossible — to devise a general rule which encompasses all the appropriate incentives to induce the trustees. But are below-market investments proper for pension plans at all, even where external incentives fully compensate them? Given the strong opposition to market-rate ETI investments that has surfaced, the subsidized investment alternative is sure to face even more hostility.

For answers to such questions as whether to provide incentives, and what kinds of incentives, and under what circumstances, legislation best deals with these issues. Ideally, the highly qualified members of a blue ribbon commission would develop such legislation. Preferably, the balanced group would come from government, industry, the consulting community, and academia, all institutions which can bring to the subject cumulative experiences and diverse viewpoints, and out of which an informed consensus could emerge. Legislation that such a commission sponsored would not only be well drafted; it would also have the best chance of passing.

But whatever legislation may permit trustees to accept incentives to invest with impunity, it should not be the state's, for this legislation clearly falls under the preemption rule — even apart from the preemption rule's role in public pension funds. Besides, attempting to get bills through all the state legislatures is a slow process. Further, the legislation will inevitably vary greatly from state to state — not a satisfactory result where the investments fan across state borders and it is uncertain what law governs. Federal legislation, then, is clearly the *desideratum*.

As a matter of policy, of course, states can impose special rules on private pension plans within their jurisdictions, just as some already have done in case of public pension funds. States can even act to the point of requiring that trustees invest minimum amounts of public pension funds in the investments the state legislatures have designated. But, first, the federal statutes must change to permit state action. And in order to har-

monize the special rules of the states, federal law should define the permissible parameters for state legislation.

The problem is not just offsetting below-market returns, but even incentivizing investments showing market returns. Investors — certainly institutional investors — who traditionally stay within traditional investment media will probably avoid making investments that involve high-risk opportunities. In the letter to Rep. Saxton which I cite above, the writer quoted a 1984 speech given by Robert A. G. Monks, who was then the Administrator of DOL's Pension and Welfare Benefit Administration. He said:

[A trustee] had no financial incentive to achieve superior results. He minimized possible liability not by taking chances in the pursuit of profit maximization but by avoiding errors. He limited his investments to securities, industries and companies legitimized by other trustees. A whole class of trustees could hardly be found to have acted imprudently. Thus, the importance of being where the rest of the class was (is) one factor driving down returns for pension funds.<sup>101</sup>

## XV. DOES MARKET RETURN ASSURE MARKET RESPONSE?

Some commentators argue that market-rate ETIs require no special consideration to assure adequate investments. If the returns on ETIs are required to be economically neutral, they argue, the market will find its way to them and thus eliminate the need for a permissive governmental posture.<sup>102</sup> I beg to differ. The market does not discover all investments, and the markets do not extend their bounty equally to all investment vehicles, given proper returns. It is therefore a fiction to assume that the market is uniformly active and efficient.<sup>103</sup> The best remedy is to permit investors with special interests to vote with their feet, so to speak, by deliberately and openly singling out investments which the market would ignore.

This remedy would work especially for pension plan fiduciaries, who must meet the commands of ERISA, such as the exclusive benefit rule. The fiduciaries will less likely make investments in ETIs because of risk — not in the investment, but to themselves — and such defensive investing distorts the market drastically for ETI securities. Pension

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<sup>101</sup> See *supra* note 30.

<sup>102</sup> See, e.g., *Phone DOL*, *supra* note 10, at 336. See generally Alicia H. Munnell, *The Pitfalls of Social Investing: The Case of Public Pensions and Housing*, NEW ENGLAND ECON. REV. Sept./Oct. 1983, at 20.

<sup>103</sup> See *Phone DOL*, *supra* note 10, at 338.

funds, after all, probably hold as much as one-third of corporate equity.<sup>104</sup> Assuming that public pensions, which represent between 25 and 30 percent of the pension fund sector,<sup>105</sup> have invested in ETIs to a modest extent,<sup>106</sup> and also assuming that DOL rules do not directly affect them, there is still over 70% of pension fund dollars out of ETI play. It is nothing but a self-defeating prophecy to justify keeping pension funds out of that market because the market will operate well without them when it is in fact a vastly different market without these pension funds.

## XVI. INVESTMENT VERSUS DISINVESTMENT

So far, this discussion has dealt exclusively with the pros and cons of selecting investments for their communitarian values. It has not included the separate matter of plan fiduciaries blocking out a group of investments from their screens, or disinvesting, because of perceived negative social implications: the issuer manufactures an allegedly harmful product (tobacco and alcohol, for example); the issuer employs non-union labor, discriminates, or supports anti-Israel boycotts. Of course, *not* making an investment because of its social implications is the inverse of an ETI. Different considerations and legal consequences attend the non-investment, especially where it effectively denies a pension plan reasonable investment alternatives or adequate diversification.<sup>107</sup>

While Langbein and Posner's "uncompensated risk of inadequate diversification"<sup>108</sup> might be a remote eventuality, we can argue that even

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<sup>104</sup> See GAO REPORT, *supra* note 93, at 4; Romano, *supra* note 31, at 44 (reporting that pension funds held 26 percent of corporate equity in 1989). Extrapolating the enormous growth in the intervening six years, the text estimates 33-1/3 percent.

<sup>105</sup> The GAO REPORT, *supra* note 93, puts the number at 23 percent in 1992, while Professor Romano, *supra* note 31, estimates 30 percent in 1989.

<sup>106</sup> The conservative estimate is that such investments account for less than five percent of public pension assets. See The GAO REPORT, *supra* note 93, at 8 (noting in a 1992 survey that a group of large public plans had invested approximately 2-1/2 percent of their assets in ETIs).

<sup>107</sup> We can direct fair criticism at programs that deny pension plans investment opportunities in so many industries that "an optimally diversified portfolio cannot be constructed from the remainder." DISINVESTMENT, *supra* note 10, at 15. Not uncommonly, collectively bargained plans exclude investments in non-union shops. See DOL Letter, *supra* note 83 (Department approved use of a union-only litmus test on condition that the test did not materially diminish the plan's investment choices). See also EMPLOYEE BENEFITS LAW 290 (1991). The statement of the AFL-CIO EXECUTIVE COUNCIL, GUIDELINES FOR THE INVESTMENT OF UNION PENSION FUNDS (Aug. 18, 1987) demonstrates the bias in favor of the union-made label; it adjures against the investment of pension funds "in ways that are detrimental to those for whom they are held in trust," and urges that priority be given, *inter alia*, to investment in "union-built construction as well as other programs designed to increase employment[,] . . . housing for workers and retirees . . . (and) companies which respect employees' rights and have good records on collective bargaining, occupational health and safety, plant closing and human rights." A copy of these "guidelines" is on file with the author.

<sup>108</sup> Langbein & Posner, *supra* note 43, at 88.

where it is not a factor, there is still a case against economic boycotting by pension fund trust fiduciaries, at least where there is an act of disinvestment. The transaction costs by themselves are too high.

But our case against exclusion could rest on a broader base. In a speech to the International Foundation of Employee Benefit Plans, a former administrator of the DOL Office of Pension and Welfare Programs made the case against exclusion:

[R]uling out certain investments completely, such as non-union companies or competitors, runs the risk of violating ERISA. This is because it is difficult to square an investment policy of exclusion on the basis of non-objective economic investment criteria, whether the exclusion of union organized companies or non-organized companies, with ERISA standards that plan assets be managed prudently, solely in the interest of the participants, and for the exclusive purpose of paying benefits. Analysis of these standards, which encompass duties of care and loyalty, leads to the inescapable conclusion that any plan which for so-called social purposes excludes investment possibilities without consideration of their economic and financial merit is showing insufficient care for and disloyalty to individuals covered by the plans. Fiduciaries following such a course would in my view be acting at their peril.

Anyone interested in "social investing" by funds would be well advised to forsake a policy of exclusion and to instead pursue a policy of inclusion. The more promising approach is to broaden the number and types of investment vehicles money managers will examine for investment purposes.<sup>109</sup>

## XVII. DO GOOD BUT DO WELL

"Oh, well. You may have lost your pension, but you saved your city."

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<sup>109</sup> See Lanoff, *supra* note 81 (edited version of the Lanoff speech). Arguably, an issue might also arise under the Sherman antitrust act: A group of pension funds essentially engages in a boycott by collectively declining investments in protest of the issuer's social policies. The collective action does resemble businesses refusing to deal for commercial purposes, but joint activities of pension funds are still probably outside the reach of the Sherman Act — at least where the pension trusts' "boycott" does not serve commercial interests. For further analysis of this issue, see BANK, NON-TRADITIONAL INVESTMENT OF PENSION FUNDS - A BRIEF OVERVIEW OF THE ANTITRUST QUESTION, included in Working Papers of President's Commission on Pension Policy (Dec. 1980).

This is no consolation to the retired worker who no longer has a monthly income. I personally learned this lesson when a retired teacher named me (he did not name several other federal officials who had an equal hand in the incident) as the one who approved New York City's borrowing from his pension fund. Note: The teacher actually did not lose any money. He just lost sleep from worrying that he *might* lose his pension.<sup>110</sup>

The DOL's IB 94-1 would free pension trustees from the risks of such an investment, but not free them of the responsibility to act prudently. Under it, merely making an investment because it will build a bridge would not amount to a *per se* violation of fiduciary obligations. That goal is irrelevant because under IB-94, the only question is whether the investment compromises the return rates and interests of the pensioners.

"Do good as long as you do well" is the subtext of IB 94-1. It seemed the right approach to me in 1975, and it still does now. Five trillion dollars can build a lot of bridges. But this is the downside: There is a chance that a trustee can compromise the prudence standard. The trustee is, after all, partial to the collateral benefits of the investment, and is subject to pressures from public officials and private interest groups. The DOL has warned in its announcement that endorsing ETIs does not sanction subordinating the plan's interests. But that warning is easier to state than follow. Not all trustees will follow it, and there is the rub.

That might be the most troublesome thing about IB 94-1. Only the most sophisticated pension fiduciary might appreciate that DOL's approving ETI investments *under proper circumstances* does not preclude the DOL — and participants — from challenging those same investments by DOL itself, where all the other bars to risky investments are not successfully cleared. Thus, the lulling effect of IB 94-1 might be its most objectionable feature.

But the DOL will not come after a plan fiduciary first for making an ETI investment. It will come after the fiduciary for making an *imprudent* investment. As with all pension trust investments, the test is not whether the investment went bad, but whether the trustee exercised the proper care and diligence when selecting the investment. The "do well" part of the formula does not require that the investment flourish, but only that the investor do well in discharging one's selection responsibilities. All IB 94-1 does, then, is indicate that the DOL is not against the fiduciary's considering collateral issues in the final selection.

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<sup>110</sup> Withers v. Teachers' Retirement System, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

Professor Zelinsky has credited me for suggesting that collateral considerations can act as a "tie-breaking criterion."<sup>111</sup> I am tempted to plead *nolo contendere*, for Professor Zelinsky describes "my suggestion" so well:

Pension trustees either must use some criterion to select from among commensurate alternatives or must select from among such alternatives randomly; ETI-type benefits are as good as any other possible tie-breaking criterion and are more seemly than random selection.<sup>112</sup>

Actually, I do not conceive the process as a tie-breaking mechanism; the investment is already targeted before the fiduciary begins selecting it. The fiduciary's task, rather, is to demonstrate that the choice of investment does not involve any concessionary sacrifice when it compares it with other comparable investments. Professor Zelinsky writes that this can be a time-consuming and costly exercise, and his is a fair comment. So, we should throw those costs on the scale and weigh them in the balance.

## XVIII. CONCLUSION

These are the tough questions: the general issue of societal investing for pension plans; the standards the trustees must employ (type of program, portion of plan assets); the appropriate incentives (if, indeed, any are appropriate) to entice trustees into targeted investments; whether targeted investing in high risk programs — even with protective devices and subsidies — is permissible at all no matter how worthy the cause; and what law (state or federal) should determine these questions.

Five trillion dollars now floats in a pension solution. The spirit of the Pension Law does not prohibit engaging some of this wealth in the service of the nation, consistent with the dictates of diversification. It is, in fact, a worthy goal, and if we can attain it, this goal would elevate pensions to a new level of service that could create stronger communities, more successful business, even stronger pensions. And if all the pension capital of these successful communities and businesses went back to work to create even more successes, pension funds could become a potent force in the economy indeed, and a powerful counterbalance to political lobbying. That is a heady challenge.

But this goal must not compromise or obscure in any way the primary function of pension plans and the reason they have preferred tax status in the first place. Tension can exist between the two goals that can lead to sharp divergences of view, as the radically different viewpoints

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<sup>111</sup> Phone DOL, *supra* note 10, at 348 n. 53.

<sup>112</sup> *Id.* at 348.

between the vice chairman of the Congressional Joint Economic Committee and the Assistant Secretary of Labor clearly demonstrate, and even as the more civil exchanges between Professor Zelinsky and myself demonstrate.

There is no need to rush to a conclusion. Again, a prestigious public commission may have the answers. The members of such a body would be chosen from the government as well as the affected private communities. It would work outside of the limelight and it would break ties in a way I can endorse. It offers the best hope for addressing objectively the issues I have raised and for crafting credible solutions, averting scandals, saving pensions, avoiding future government bailouts. And, finally, it might spare public officials like I once was from the lawsuits of insomniac pensioners.



